STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
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February 26, 2010

Dear Interested Party:

Enclosed is the Discussion Paper on Regulation 1507, *Technology Transfer Agreements*. Discussion regarding proposed amendments to Regulation 1507 is scheduled for the Board's **May 25, 2010, Business Taxes Committee** meeting.

However, before the issue is presented at the Business Taxes Committee meeting, staff would like to provide interested parties an opportunity to discuss the issue and present any suggested changes or comments. Accordingly, a meeting is scheduled in **Room 122 at 10:00 a.m. on March 11, 2010**, at the Board of Equalization; 450 N Street; Sacramento, California.

If you are unable to attend the meeting but would like to provide input for discussion at the meeting, please feel free to write to me at the above address or send a fax to (916) 322-4530 before the March 11, 2010 meeting. If you are aware of other persons that may be interested in attending the meeting or presenting their comments, please feel free to provide them with a copy of the enclosed material and extend an invitation to the meeting. If you plan to attend the meeting on March 11, 2010, or would like to participate via teleconference, please contact Ms. Cecilia Watkins at (916) 445-2137 or by e-mail at cecilia.watkins@boe.ca.gov prior to March 9, 2010. This will allow staff time to make alternative arrangements should the expected attendance exceed the maximum capacity of Room 122 and to arrange for teleconferencing. In addition, please let Ms. Watkins know if you wish to have future correspondence, including the Issue Paper and all attachments, sent to your e-mail address rather than to your mailing address.

Whether or not you are able to attend the above interested parties' meeting, please keep in mind that the due date for interested parties to provide written responses to staff's analysis is **March 26, 2010.** Please be aware that a copy of the material you submit may be provided to other interested parties. Therefore, please ensure your comments do not contain confidential information.

Thank you for your consideration. I look forward to your comments and suggestions. If you have any questions, please contact Ms. Leila Hellmuth, Supervisor, Business Taxes Committee Team, at (916) 322-5271.

Sincerely,

Jeffrey L. McGuire, Chief
Tax Policy Division
Sales and Use Tax Department

JLM: caw

Enclosures

cc: (all with enclosures)
Honorable Betty T. Yee, Chairwoman, First District (MIC 71)
Honorable Jerome E. Horton, Vice-Chair, Fourth District
Honorable Bill Leonard, Member, Second District (MIC 78)
Honorable Michelle Steel, Member, Third District
Honorable John Chiang, State Controller, c/o Ms. Marcy Jo Mandel
via e-mail:
Mr. Alan LoFaso, Board Member's Office, First District
Mr. Gary Qualset, Board Member's Office, First District
Ms. Mengjun He, Board Member's Office, First District
Mr. Doug Anderson, Board Member's Office, Fourth District
Mr. Lee Williams, Board Member's Office, Second District
Mr. Ken Maddox, Board Member's Office, Third District
Mr. Neil Shah, Board Member's Office, Third District
Ms. Elizabeth Maeng, Board Member's Office, Third District
Ms. Natasha Ralston Ratcliff, State Controller's Office
Mr. Ramon J. Hirsig
Ms. Kristine Cazadd
Ms. Randie L. Henry
Mr. Jeff Vest
Mr. Randy Ferris
Mr. Robert Lambert
Mr. Bradley Heller
Mr. Robert Tucker
Mr. Todd Gilman
Ms. Laureen Simpson
Mr. Robert Ingenito Jr.
Mr. Bill Benson
Ms. Freda Orendt
Mr. Stephen Rudd
Mr. Kevin Hanks
Mr. James Kuhl
Mr. Geoffrey E. Lyle
Ms. Leila Hellmuth
Ms. Cecilia Watkins
Ms. Lynn Whitaker

DISCUSSION PAPER

Proposal to Amend Regulation 1507*, Technology Transfer Agreements*

Issue

Regulation 1507 implements, interprets, and makes specific the provisions of Revenue and Taxation Code (RTC) sections 6011, subdivision (c)(10), and 6012, subdivision (c)(10), that relate to technology transfer agreements (TTA). The issues raised in this paper are whether Regulation 1507 should be amended to:

- Further clarify the definition of TTA, including clarifying the requirement that a TTA must clearly identify the copyright or patent interest being transferred;
- Further explain and illustrate that agreements are not TTAs merely because they transfer the right to use tangible personal property, such as a computer program, that is subject to a copyright or patent interest; and
- Clarify the definition for the term "computer program," as used in Regulation 1507, by revising the definition to refer to the definition for the term "program," provided in Regulation 1502, *Computers, Programs, and Data Processing*.

Background

RTC sections 6011, subdivision (c)(10), and 6012, subdivision (c)(10), define a "technology transfer agreement" to mean "any agreement under which a person who holds a patent or copyright interest assigns or licenses to another person the right to make and sell a product or to use a process that is subject to the patent or copyright interest." The statutes further provide that "sales price" and "gross receipts" do not include the amount charged for intangible personal property transferred with tangible personal property in any TTA, if the TTA separately states a reasonable price for the tangible personal property.

Among other things, Regulation 1507 currently provides that: "a technology transfer agreement does not mean an agreement for the transfer of any tangible personal property manufactured pursuant to a technology transfer agreement, nor an agreement for the transfer of any property derived, created, manufactured, or otherwise processed by property manufactured pursuant to [the] technology transfer agreement. A technology transfer agreement also does not mean an agreement for the transfer of prewritten software as defined in subdivision (b) of Regulation 1502, *Computers, Programs, and Data Processing*."

Regulation 1507 incorporates the California Supreme Court's holding in *Preston v. State Board of Equalization* (2001) 25 Cal.4th 197 (*Preston*). The court in *Preston* found that RTC sections 6011's and 6012's TTA provisions apply to transactions where the holder of a copyright or patent interest clearly transfers the "right to make and sell a product" subject to the patent or copyright interest or to use a patented process along with tangible personal property, under the terms of a written agreement.

Regulation 1507 implements, interprets, and makes specific the terms "process," "assign or license," "copyright interest," and "patent interest," from RTC sections 6011, subdivision (10)(D), and 6012, subdivision (10)(D). As relevant here, the regulation currently defines "process" to mean: "one or more acts or steps that produce a concrete, tangible and useful result that is patented by the United States Patent and Trademark Office, such as the means of

manufacturing tangible personal property. Process may include a patented process performed with an item of tangible personal property, but does not mean or include the mere use of tangible personal property subject to a patent interest." (Regulation 1507, subd. (a)(3).)

In addition, Regulation 1507, subdivision (a)(1), example 3, explains that under the TTA provisions, tax will not apply to charges for the right to use a patented process that is external to tangible personal property, but tax will apply to charges for the transfer of tangible personal property, including charges for the right to use a patented process that is embedded in the tangible personal property.

Discussion

The proposed amendments to Regulation 1507 illustrated in attached Exhibit 1 do not reinterpret the provisions of RTC sections 6011 and 6012. Rather, they are intended to further clarify the Board's longstanding interpretation of these statutes and further illustrate the current application of the regulation.

Board staff understands that some taxpayers are contending that RTC sections 6011's and 6012's TTA provisions and/or Regulation 1507 exclude charges for the right to use a prewritten computer program that incorporates or performs an embedded patented process. Specifically, they apparently argue that the "end user" software licensing agreements constitute TTAs and that the TTA provisions therefore exclude all the charges to use whatever patented processes are incorporated into the design of the transferred prewritten computer programs.

Board staff believes that this interpretation conflicts with RTC sections 6011 and 6012 and the current provisions of Regulation 1507 regarding transfers of the right to use tangible personal property that incorporates or performs an embedded patented process, as well as transfers of the right to use tangible personal property subject to a patent. Furthermore, Board staff also believes that this interpretation is inconsistent with Regulation 1502, which implements, interprets, and makes specific the provisions of RTC section 6010.9 that prescribe the application of tax to computer programs, and RTC sections 6011 and 6012, which define "sales price" and "gross receipts" and include the TTA provisions discussed in this paper. Specifically, staff believes that this interpretation of the TTA provisions is incorrect because it purports to exclude charges for computer programs from the measure of tax that would not qualify as nontaxable charges for "custom computer programs or programming" or "custom modifications to prewritten programs," as defined in Regulation 1502.

DISCUSSION PAPER

Proposal to Amend Regulation 1507, *Technology Transfer Agreement*

Proposed Amendments

The amendments included in Exhibit 1 are proposed to do the following:

Subdivision (a)(1): Clarify the definition of a TTA, which requires an agreement that *clearly* assigns or licenses the types of copyright or patent interests specified in *Preston*; state that TTA does not mean an agreement for the mere use of tangible personal property, including a computer program, that is subject to a copyright or patent interest; update the term "prewritten software" to refer to "prewritten programs" as defined in Regulation 1502; and add Examples 3 through 6 to illustrate that the mere sale or use of tangible personal property does not qualify as a TTA.

Subdivision (a)(4): Clarify that the term "process," as used in this regulation, does not mean or include the mere use of tangible personal property in which a patented technology is embedded, by the owner of such property or the owner's customers.

Add subdivision (a)(6) to define "computer program" by reference to the definition for the term "program" provided in Regulation 1502.

Staff believes the proposed amendments will serve taxpayers by further clarifying, and implementing, defining, and making specific, the Board's longstanding interpretation of the application of the Sales and Use Tax Law to computer programs and TTAs.

Summary

While Regulation 1507 does not alter the definition of a TTA as provided under RTC sections 6011 and 6012, and while the regulation is valid as currently written, the regulation would benefit from further clarification that makes more specific the definitions of TTA and "process," and from a clear statement (with appropriate examples) that a TTA does not mean an agreement for the mere use of tangible personal property, including a computer program, that is subject to a copyright or patent interest, as mistakenly contended by some taxpayers. Accordingly, staff proposes to amend Regulation 1507 as illustrated in Exhibit 1, and welcomes comments and suggestions on this issue from interested parties.

Current as of 2/26/2010

(a) DEFINITIONS.

(1) "Technology transfer agreement" means and includes an agreement evidenced by a writing (e.g., invoice, purchase order, contract, etc.) that clearly assigns or licenses: the right to produce or reproduce, and sell, ~~a copyright interest in tangible personal property for the purpose of reproducing and selling~~ other property subject to the copyright interest;~~. A technology transfer agreement also means a written agreement that~~ or ~~assigns or licenses a patent interest for~~ the right to produce, reproduce, or manufacture, and sell, tangible personal property subject to the patent interest;~~, or a written agreement that assigns or licenses~~ or the right to use a process subject to a~~a the~~ patent interest, as defined in subdivision (a)(4). Such a~~ clear~~n assignment or license is reflected in a written agreement that:

(A) Identifies a copyright or patent interest that includes the right to produce or reproduce, and sell, other tangible personal property subject to the copyright or patent interest and clearly assigns ownership of that interest;

(B) Identifies a copyright or patent interest and clearly licenses the right to produce, reproduce, or manufacture, and sell, other tangible personal property subject to that interest; or

(C) Identifies a patent interest and clearly licenses the right to use a process subject to that interest, as defined in subdivision (a)(4).

A technology transfer agreement does not mean or~~and~~ include an agreement for the transfer of any tangible personal property produced, reproduced, or manufactured pursuant to the ~~a technology transfer~~ agreement, nor an agreement for the transfer of ~~any~~ property derived, created, manufactured, or otherwise processed by property produced, reproduced, or manufactured pursuant to the technology transfer agreement, nor an agreement for the mere use of tangible personal property, including a computer program, that is subject to a copyright or patent interest, by the owner or its customers. A technology transfer agreement also does not mean or~~and~~ include an agreement for the transfer of prewritten programs ~~software~~ as defined in ~~subdivision (b) of~~ Regulation 1502, *Computers, Programs, and Data Processing*.

Example No. 1: Company X holds a copyright in certain tangible artwork. Company X transfers (temporarily or otherwise) its artwork to Company Y and, in writing, transfers (temporarily or otherwise) a copyright interest to Company Y authorizing it to reproduce and sell tangible personal property subject to Company X's copyright interest in the artwork. Company X's transfer of artwork and copyright interest to Company Y constitutes a technology transfer agreement. Company Y's sales of tangible personal property containing reproductions of Company X's artwork do not constitute a technology transfer agreement.

Example No. 2: Company X holds patents for widgets and the process for manufacturing such widgets. Company X, in writing, transfers (temporarily or otherwise) its patent interests to sell widgets and the process used to manufacture such widgets to Company Y. Company X's transfer of its patent interests to Company Y constitutes a technology transfer agreement. Company Y's sale or storage, use, or other consumption of any widgets that it manufactures does not constitute a technology transfer agreement. Company Y's sale or storage, use, or other consumption of any tangible personal property used to manufacture widgets also does not constitute a technology transfer agreement.

Example No. 3: Company X has a patent interest in a word-processing program. Company X enters into an agreement, in writing, that only allows Company Y and its employees to use the computer program for word-processing purposes in the operation of its business. The agreement does not constitute a technology transfer agreement.

Example No. 4: Company X has a patent interest in a computer program that operates a specific type of equipment. Company X enters into an agreement, in writing, that only allows Company Y to use the computer program for the operation of such equipment. The agreement does not constitute a technology transfer agreement.

Example No. 5: Company X has a patent interest for processes included in a digital device that cuts hair. Company X enters into a written agreement for the sale of the device to Company Y, a hair salon, that only allows Company Y, and its employees, to use the device to cut hair in the operation of its business. The agreement does not constitute a technology transfer agreement.

Example No. 6: Company X has a patent interest for processes included in digital devices that are incorporated into automobiles. Company X enters into a written agreement for the sale of automobiles including the devices to Company Y, an automobile rental company, to use the automobiles in its rental car business. Company Y will rent the automobiles to its customers, who will themselves drive and otherwise use the automobiles during the rental agreement period. The agreement does not constitute a technology transfer agreement.

Example No. ~~3~~7: Company X manufactures and leases a patented medical device to Company Y. As part of the lease of the medical device, Company X also transfers to Company Y, in writing, a separate patent interest in a process external to the medical device that involves the use, application or manipulation of the medical device. Company X charges a monthly rentals payable for the equipment as well as a separate charge for each time the separate patented process external to the medical device is performed by Company Y. Company X's lease of the medical device to Company Y to perform the separately patented process is not a technology transfer agreement and tax applies to the entire rentals payable for the medical equipment. Company X's transfer of its separate patent interest for the right to perform the separate patented process external to the medical device is a technology transfer agreement. Company X's separate charges to Company Y for the right to perform the separate patented process external to the medical device are not subject to tax provided they relate to the right to perform the separate patented process, are not for the lease of the medical device, and represent a reasonable charge for the right to perform the separate patented process external to the medical device. Where the separate charges for the right to perform the separate patented process relate to the patented technology embedded in the internal design, assembly or operation of the medical device, Company X's separate charges for the right to perform the separate patented process are not pursuant to a technology transfer agreement and are instead part of the rentals payable from the lease of the medical device.

(2) "Copyright interest" means the exclusive right held by the author of an original work of authorship fixed in any tangible medium to do and to authorize any of the following: to reproduce a work in copies or phonorecords; to prepare derivative works based upon a work; to distribute copies or phonorecords of a work to the public by sale or other transfer of ownership, or by rental, lease, or lending; to perform a work publicly**,** in the case of literary, musical, dramatic, and choreographic works, pantomimes, and motion pictures and other audiovisual works; to display a copyrighted work publicly, in the case of literary, musical, dramatic, and choreographic works, pantomimes, and pictorial, graphic, or sculptural works, including the individual images of a motion picture or other audiovisual work; and in the case of sound recordings, to perform the work publicly by means of a digital audio transmission. For purposes of this regulation, an "original work of authorship" includes any literary, musical, and dramatic works; pictorial, graphic, and sculptural works; motion pictures and other audiovisual works; sound recordings, including phonograph and tape recordings; and architectural works represented or contained in tangible personal property.

(3) "Patent interest" means the exclusive right held by the owner of a patent issued by the United States Patent and Trademark Office to make, use, offer to sell, or sell a patented process, machine, manufacture, composition of matter, or material.

(4) "Process" means one or more acts or steps that are ~~produce a concrete, tangible and useful result that is~~ patented by the United States Patent and Trademark Office~~, such as the means of manufacturing tangible personal property~~. Such separate patented processes may either be external to a product or relate to a patented technology embedded in the internal design, assembly or operation of a product. As used in this regulation, "~~P~~process"~~ may include a patented~~

~~process performed with an item of~~ ~~tangible personal property, but~~ does not mean or include the mere use of tangible personal property in which~~subject to~~ a patented ~~interest~~technology is so embedded, by the owner of such property or the owner's customers.

(~~4~~5) "Assign or license" means to transfer clearly in writing a ~~patent or~~ copyright or patent interest to a person who is not the original holder of the copyright or patent ~~or copyright~~ interest where, absent the assignment or license, the assignee or licensee would be prohibited from making any use of the copyright or patent provided in the written~~technology transfer~~ agreement.

(6) For purposes of this regulation, "computer program" means a "program" as defined in Regulation 1502, *Computers, Programs, and Data Processing*.

(b) APPLICATION OF TAX

(1) Tax applies to amounts received for any tangible personal property transferred as part of a technology transfer agreement. Tax does not apply to amounts received for the assignment or licensing of a copyright or patent ~~or copyright~~ interest as part of a technology transfer agreement. The gross receipts or sales price attributable to any tangible personal property transferred as part of a technology transfer agreement shall be:

(A) The separately stated sale price for the tangible personal property, provided the separately stated price represents a reasonable fair market value of the tangible personal property;

(B) Where there is no such separately stated price, the separate price at which the tangible personal property or like tangible personal property was previously sold, leased, or offered for sale or lease, to an unrelated third party; or,

(C) If there is no such separately stated price and the tangible personal property, or like tangible personal property, has not been previously sold or leased, or offered for sale or lease to an unrelated third party, 200 percent of the combined cost of materials and labor used to produce the tangible personal property. "Cost of materials" consists of those materials used or otherwise physically incorporated into any tangible personal property transferred as part of a technology transfer agreement. "Cost of labor" includes any charges or value of labor used to create the tangible personal property whether the transferor of the tangible personal property contributes such labor, a third party contributes the labor, or the labor is contributed through some combination thereof. The value of labor provided by the transferor of the tangible personal property shall equal the separately stated, reasonable charge for such labor. Where no separately stated charge for labor is made, the value of labor shall equal the lower of the taxpayer's normal and customary charges for labor made to third persons, or the fair market value of such labor performed.

(2) Tax applies to all amounts received from the sale or storage, use, or other consumption of tangible personal property coupled with a copyright or patent ~~or copyright~~ interest, where the transfer is not pursuant to a technology transfer agreement.

(3) Specific Applications. Tax applies to the sale or storage, use, or other consumption of artwork and commercial photography pursuant to a technology transfer agreement as set forth in Regulation 1540, *Advertising Agencies and Commercial Artists.*